ARKLA, INC.

PITAL STRUCTURE

NG TERM DEBT

Issue	Rating	Amount Outstanding	Times Charges Earned 1988	1987	Interest Dates	Call Price	Price Range 1988	1987
First $8^{1}/_{2}$s, 1992	[2]	$19,750,000			M&S 30	[1]	[2]	[2]
First 9 30s, 1996	A2	13,750,000			J&D 1	[1]102 54		
First 9.10s, 1998	A2	32,495,000			A&O 1	[1]104 00	$99^{1}/_{8}$- $91^{5}/_{8}$	$93^{7}/_{8}$- $91^{1}/_{8}$
First $9^{3}/_{4}$s, 1999	[2]	17,500,000			M&S 30	[1]	[2]	[2]
First $11^{3}/_{4}$s, 2003	A2	18,885,000			M&S 1	[1]107 833	$110^{1}/_{2}$- $100^{7}/_{8}$	$108^{1}/_{8}$- $98^{1}/_{2}$
First $11^{1}/_{8}$s, 2003	A2	28,172,000			A&O 17	[1]107 417	107 - $100^{3}/_{8}$	$106^{1}/_{4}$- $96^{1}/_{2}$
Debenture 8.90s, 2006	A2	150,000,000			J&D15	N C.	$94^{3}/_{4}$- $88^{3}/_{8}$	99 - $80^{1}/_{2}$
8% notes, 1997	A2	150,000,000	2 52	2 71	J&J15	[5]100	$92^{7}/_{8}$- $88^{1}/_{2}$	$99^{3}/_{4}$- $83^{1}/_{4}$
Debenture $9^{7}/_{8}$s, 2018	A2	200,000,000			F&A15	[1]109.38	$100^{5}/_{8}$- $93^{1}/_{8}$	[4]
9 45% notes, 1995	A2	150,000,000			A&O 15	N C	100 - $97^{1}/_{4}$	
Other debt		604,000						
Assumed Debt								
Mississippi River Transmission Corp 12 55% senior notes, 1991	[2]	40,000,000						
Entex, Inc. first $6^{1}/_{2}$s, 1989	A2	27,304,000			J30&D31	100 00	$97^{1}/_{2}$- $95^{1}/_{4}$	$95^{5}/_{8}$-$94^{1}/_{2}$
Entex, Inc. first $8^{7}/_{8}$s, 2001	A2	21,880,000			J&D1	104 02	100 - $87^{3}/_{8}$	$94^{1}/_{2}$-79
Entex, Inc. s.f. deb. $11^{3}/_{8}$s, 1998	A2	75,000,000			M&N1	105 22	$105^{5}/_{8}$- $100^{1}/_{8}$	107 -$97^{3}/_{4}$

PITAL STOCK

Issue	Par Value	Rating	Shares Outstanding	Earned per Sh 1988	1987	Divs per Sh 1988	1987	Call Price	Price Range 1988	1987
$3 conv exch. pfd, A	$0 10	"a3"	2,600,000	$48 00	$44 60	$3 00	$2 125	[6]$25 10	43 -$36^{3}/_{4}$	59 -$34^{1}/_{2}$
Common	0 $62^{1}/_{2}$		[3]84,387,000	[3]1 39	[3]1 31	1 08	$1 08		$20^{5}/_{8}$- $17^{3}/_{4}$	$26^{1}/_{2}$- $15^{5}/_{8}$

Prices subject to change, certain issues also callable for sinking fund (see text) [2]Privately held [3]As reported by Co on avg shs based on continuing [4]Offered Feb 10, 1988 [5]Beginning on or after Jan 15, 1994 [6]Beginning on or after March 15, 1990

STORY

Incorporated in Delaware Mar. 9, 1928, as thern Cities Distributing Co On Nov. 30, 1934, changed to Arkansas Louisiana Gas Co company merged and succeeded to the business of Public Utilities Corp of Arkansas, Arkansas-Louisiana Pipe Line Co. and Reserve Natural Co of Louisiana, all of which were formerly sidiaries of Arkansas Natural Gas Corp (parent company). Present name adopted on Nov 12, In 1935 company acquired certain additional erties of Arkansas Natural Gas Corp On 30, 1936, acquired and merged the property Little Rock Gas and Fuel Co and in consideration assumed all obligations

Upon the completion of the foregoing merger acquisitions, the company had acquired and in had succeeded to the business represented the operation of all the natural gas properties Arkansas, Louisiana and Texas formerly owned Arkansas Natural Gas Corp and subsidiaries

June 1, 1941 company purchased the distribution system of Camden Gas Corp, Camden,

On Sept. 15, 1943 company purchased the gas distribution system of Consumers Gas Co, Hot Springs, Ark

In 1957, formed Arkansas Cement Corp, and through Arkla Air Conditioning Corp, newly formed, acquired air conditioning division and Evansville plant of Servel, Inc for $3,675,000

On Aug 31, 1960, Consolidated Gas Utilities (Del) and its subsidiary, Hickory Co., were merged on basis of one share new $0.90 cumulative convertible $20 par preference stock for each common share.

In June 1961, acquired Ingersoll Corp (now Equipment Co), Shreveport, La, makers of valves and compressors, which, together with 2 subsidiaries, was merged (as divisions) into subsidiary, Arkla Industries Inc. (formerly Arkla Air Conditioning Corp)

On Sept. 30, 1961, merged Southwest Natural Gas Co on a one-for-5 common share exchange (292,013 total common shares issued)

On Oct. 31, 1961, merged MidSouth Gas Co. on one-for-2 common share exchange basis (336,000 common shares issued)

In 1966, acquired Crossett, Ark. and Cheyenne, Okla, distribution systems and sold distribution properties in western Texas near Stephenville.

On Apr 11, 1974, a sale was consummated between Arkansas Louisiana Gas Co, Arkla Chemical Corp and SOPAG International of Paris, France, for Arkla's Chemical Fertilizer Division, for a total consideration of $75.5 million, with a down payment of $17 million made on closing, a balance for $22 million being paid at $1 million per month with interest beginning in Dec. 1974, and lease payments in amounts which will be used to retire $33.9 million principal amounts of municipal bonds presently outstanding.

In Mar. 1975, company sold its Forest Products division to International Paper Co. A net gain of approx. $5 million was realized on this sale

On June 11, 1984 sold two divisions of Arkla Industries, Inc. to Preway, Inc for about $,000,000 The majority of the remaining divisions were sold to Castle W. Jordan, pursuant to agreement reached in Aug 1984, for approximately $21,000,000 Arkla Industries is presently a non-operating subsidiary

In Sept. 1985, sold Arkansas Cement Corp to Ash Grove Cement Co for $38,000,000.

On June 30, 1986, purchased Mississippi River Transmission Corporation from MidCon Corp for $,000,000.

In July, 1986, acquired Transark Pipeline for $,000

At year end 1986, acquired Arkoma Production Company for $14,000,000 million, plus the assumption of $35,000,000 in debt.

On Feb, 2, 1988, Arkla completed its merger with Entex, Inc. The merger agreement provided for each share of Entex's common stock to be converted into 1.15 shares of Arkla common stock. The approximate equity value of the transaction was nearly $500 million

In July, 1989, Company acquired Louisiana Intrastate Gas Corp (LIG), an 1800 - mile Louisiana gas pipeline system, and certain related properties In connection with the acquisition, Company issued 2,250,000 shares of Company common stock and assumed existing LIG debt, resulting in an acquisition cost of approximately $170,000,000

SIMPLIFICATION PLAN

In connection with the proceeding against Arkansas Natural Gas Corp., under Sec. 11(b)(2) of Public Utility Holding Company Act, that corporation joined with Cities Service Co in filing with the SEC on Dec. 4, 1951, an amended plan for the simplification of its corporate structure, pursuant to Sec 11(e) of the Act.

On Oct. 1, 1952, the SEC approved amended plan, and on Jan 29, 1953 the U S District Court of Delaware, issued an enforcing order Certain public stockholders of Arkansas Natural appealed to the U S Court of Appeals, which affirmed the order of the District Court. Application for writ of certiorari to U S Supreme Court was denied Effective date of plan was March 30, 1953 The amended plan as consummated (with exception, see above) is summarized as follows

(a) Company transferred to Arkansas Fuel, a former affiliate of the company and non-utility subsidiary of Arkansas Natural, interest in certain gas production properties, including leases, gas wells, equipment and field gathering lines, at net book value ($3,746,636), and Arkansas Fuel transferred to company natural gasoline plants operated by Arkansas Fuel and located on pipeline system at net book value including inventories ($7,112,685),

(b) Arkansas Natural transferred to company pipeline property owned by Arkansas Natural but operated by company, consisting of approximately 51 miles of pipeline extending from the Monroe Gas Field to a point near Norphlet, Ark. in the El Dorado area, at net book value ($45,983) to be paid by company to Arkansas Natural,

(c) Arkansas Natural surrendered to company for cancellation latter's $6,500,000 debenture $4^{1}/_{4}$s as a donation of capital,

(d) Company reclassified outstanding common stock so as to consist of 3,801,609 common shares, par $5, which were distributed to the common and class A common stockholders of Arkansas Natural on basis of 1/2 share for each class A and common share

BUSINESS

Engaged principally in production, purchase, gathering, products extraction, transmission and direct distribution and sale of natural gas to approx 2 million domestic, commercial, industrial and other customers in over 1,000 communities in Arkansas, Kansas, Louisiana, Oklahoma, Texas, Missouri, Illinois and Mississippi.

The major cities served at retail include Little Rock, North Little Rock, Hot Springs, Pine Bluff, Jonesboro, West Memphis, El Dorado and Texarkana, Ark, Shreveport, Ruston, Lake Chares and Bossier City, La., Lawton, Altus and Duncan, Okla, Beaumont, Houston and Texarkana, Tex., and a portion of Wichita, Kan

Company is also engaged in operation of natural gasoline plants for processing natural gas and sale of products therefrom and in gas and oil exploration and production

Activities of subsidiaries and divisions are as follows

Natural Gas Distribution — Arkla's distribution operations provide gas utility service to residential, commercial and industrial customers in more that 1,000 communities across six states Distribution has two operating divisions — Arkansas Louisiana Gas Company (ALG) and Entex

Natural Gas Transmission — The Arkla Pipeline Group (APG) conducts the interstate pipeline operations of the Company The APG has three operating units Arkla Energy Resources (AER), Mississippi River Transmission Corporation (MRT) and Arkla Energy Marketing Company (AEM)

Exploration and Production — Arkla Exploration Company (AEC) conducts the natural gas and oil exploration and production operations of the Company Arkla's substantial gas and oil reserves are located primarily in areas adjacent to its pipeline and distribution operations

PROPERTY

At March 31, 1989, Co.'s pipelines consisted of 3,596 miles of gathering lines and 6,082 miles of transmission lines ranging from two inches to 30 inches in diameter Gathering lines are located in fields in which Co produces and purchases natural gas.

In conjunction with its pipeline systems, Co has compression facilities with 317,742 installed horsepower During 1969, Co purchased an interest approximating 10% in Lake Bistineau Storage Field near Shreveport, La, from United Gas Pipeline Co Other storage facilities include the Ruston and W Unionville storage fields in N Louisiana, the Ulan, Chiles Dome and Ada storage fields in Okla., the Collinson storage field in Kansas and St Jacob storage field in Illinois

At Dec 31, 1988, Co's distribution systems consisted of 17,204 miles of mains, ranging from 1/2 inch to 20 inches in diameter, located in communities served, service area extending in most instances beyond corporate limits and, in larger cities and towns, to a considerable extent beyond such limits Distribution facilities also include services, meters and regulators Co maintains warehouse facilities located at strategic points on its system including Shreveport, Texarkana, Little Rock, Ada, Lawton, Duncan and Blackwell Co's general offices are at Shreveport, La

Production properties at Dec 31, 1988, included mineral leases on 402,551 acres (including 230 019 classified as developed acres and approximately 172,532 as undeveloped acres)

Gas Reserves: As of Dec 31, 1988, company had approximately 3 87 trillion cu ft. of recoverable gas reserves, mostly controlled under long-term purchase contracts with remainder owned

FRANCHISES

The 10 largest communities in which the Company furnishes gas service to residential, commercial and industrial customers are as follows

	City	No of Customers
1	Houston, Tx	492,468
2	Little Rock/N Little Rock, Ark	92,364
3	Shreveport/Bossier, La	83,184
4	Beaumont, Tx	29,557
5	Pasadena, Tx	27,100
6	Tyler, Tx	26,828
7	Lawton, Ok	26,743
8	Lake Charles, La	25,231
9	Laredo, Tx	20,914
10	Pine Bluff, Ark	19,462

REGULATION

As a gas pipeline and distributor serving an eight-state area, Company is subject to regulation both by state public service commissions, as well as the Federal Energy Regulatory Commission Company's sales rates to its industrial customers in Louisiana, Missouri and Illinois are not regulated Industrial sales made by Company in Texas are regulated only in those instances where the contracts with those customers are not negotiated at arm's length Domestic and commercial service

NE076

to the Company's Texas customers are also regulated by the various municipalities in which such service is provided. Company is not subject to regulation by the Securities and Exchange Commission under the Public Utility Holding Company Act.

GAS RATES AND SERVICE

DISTRIBUTION

General: The Company's distribution units provides both sales and transport services. Company generally is permitted to adjust monthly sales rates through cost of gas adjustment tariffs designed to reflect cost increases of purchased gas and a fair-field-price for company production. Company's policy is to apply regularly for rate increases in all jurisdictions in order to recover increases in its non-gas costs from both sales and transport customers.

Arkansas: Retail service in Arkansas is provided through the Company's ALG unit.

In 1987, the Company was permitted to increase its base rates by $7 6 million annually to its residential, commercial and small industrial customers, effective January 1988.

Oklahoma: Retail service in Oklahoma is provided through the Company's ALG unit. No significant developments affecting the Company's rates occurred during 1987 and 1988.

Kansas: Retail service in Kansas is provided through the Company's ALG unit. On January 13, 1987, the Kansas Corporation Commission entered an order authorizing a rate increase of $1 95 million.

Texas: Retail service in Texas is provided through both the Company's ALG and Entex units. Authorization for an increase of $1 2 million in ALG's base rates for service to its East Texas customers was received in 1987.

In May 1987, the Company's Entex unit received authorization for rate increases totaling approximately $2,500,000 for service to certain of its Texas cities. Certain of Entex's tariffs also contain provision which authorize the Company automatically to adjust its rates annually to reflect changes to its cost of service.

Louisiana: Retail service in Louisiana is provided through both the Company's ALG and Entex units. In July 1988, ALG announced the settlement of its Louisiana rate case which allowed an annual increase of $8.2 million.

In December of 1987, the Company's Entex unit was authorized to increase its rates in Louisiana by $3,200,000 annually.

Mississippi: Retail service in Mississippi is provided through the Company's Entex units. No significant developments affecting the Company's rates occurred during 1987 and 1988.

PIPELINE

General: During 1988, Company reorganized its transmission and marketing operations into the Arkla Pipeline Group (APG). Included within APG are Arkla Energy Resources (AER), an interstate pipeline operated as a division of the Company, Mississippi River Transmission Corporation (MRT), interstate pipeline subsidiary of the Company, and Arkla Energy Marketing Company (AEM), a largely unregulated subsidiary which serves as the primary large volume marketing and gas supply arm of the Company.

AER: AER currently provides both sales and transport services and is the primary supplier to the Company's ALG unit. The Federal Energy Regulatory Commission (FERC) has jurisdiction over AER with regard to its interstate pipeline business, including transportation services, while AER's deliveries to and its sales to its direct industrial customers in its traditional five state service area (Arkansas, Kansas, Louisiana, Oklahoma and Texas) are generally subject to state regulation. In 1988, AER was permitted effectively to increase the non-gas portion of its rates for its services to ALG's Arkansas operations for a two-year period by $13.5 million. Early in 1989, AER agreed to a proposed settlement with certain of its customers which will, if approved, result in an approximate $39 2 million annual increase in the non gas cost portion of its maximum lawful FERC-jurisdictional rates. On March 31, 1989, AER filed with the FERC an application to recover an additional $40 million in certain take-or-pay related costs from its FERC-jurisdictional sales customers. This application currently is pending before the FERC.

MRT: MRT currently provides solely sales services, but recently has applied to the FERC to become an open-access pipeline. If approved, MRT then will provide both sales and transport services. The FERC has jurisdiction over MRT with regard to its interstate pipeline business, while MRT's direct sales are generally not subject to any form of rate regulation. In 1988, MRT received final approval to implement an approximate $7 million increase in the non-gas portion of the rates charged to its FERC-jurisdictional customer.

SUBSIDIARIES

The following are the Company's principal wholly-owned subsidiaries:

Arkla Energy Marketing Co.

Mississippi River Transmission Corp

Arkla Exploration Co.

LETTER TO THE SHAREHOLDERS

The following is a letter to the shareholders by Thomas F. McLarty, III, Chairman of the Board, President and Chief Executive Officer of Arkla, Inc as it appeared in the Co.'s 1988 Annual Report.

To Our Shareholders:

Arkla's Mission: To achieve increasing value for our shareholders, while providing the best possible service to our customers through the efficient production, transmission, and distribution of natural gas to our customers located throughout the South Central region of the United States.

Q. In general, what kind of year did Arkla have in 1988?

A. *1988 was another solid year of performance for Arkla.*

We improved earnings in a troublesome operating environment. We completed the Entex merger — the most important acquisition in company history. We increased the capacity of our pipeline systems, and we expanded the scope of our exploration and production program.

We also made some internal organizational changes, naming Carl Quinn, President and Chief Operation Officer and Jim Wilhite, Vice Chairman. These changes better position the Company for the furture.

Standard & Poor's recent decision to add Arkla to its prestigious S&P 500 Index resulted in a renewed strengthening of our stock price, and in an increase in volumes of shares traded.

However, despite *significant progress, 1988 was* not without difficulties. Natural gas supply continued to exceed demand, putting further downward pressure on both Arkla's pipeline margins and company-owned production prices. The continued gas oversupply also caused us to increase our prepayments for gas to settle take-or-pay claims.

Q. Specifically, how did 1988 financial results compare with those in 1987?

A. For the year, Arkla had net income from continuing opertions of $124.8 million — a 7 6 percent increase over 1987.

This was primarily due to improved distribution earnings coupled with sound performance from our other lined of business. After deduction of preferred dividends, these earnings equate to $1 39 per share, which represents a 6 1 percent increase over 1987.

Our 1988 performance was particularly significant considering the mild fourth quarter weather and relatively soft gas prices. This warmer than normal fourth quarter weather cost us about $0 07 per share.

Q. Overall earnings were up for the year, but how did each of your three primary business units contribute to this performance?

A. Our distribution unit experienced the strongest gain. Operating income there showed a healthy 16 percent increase, up to $131 6 million.

This performance was achieved through tight cost controls, an Entex early retirement program and a return to normal weather in the first quarter of 1988. Also, significant economies of scale were realized through the Entex merger.

In addition, not only did we increase our number of distribution customers at both ALG and Entex, but throughput and usage per customer were also higher than in 1987.

Entex's transition into a major part of the Arkla team has gone extremely well. This is a direct reflection of the cooperative attitude and hard work displayed by these newest members of the Arkla family.

Entex chairman, Gale Galloway, played a significant and position role in assuring the success of the merger. We wish Gale well in his return to private business with the acquisition of Louisiana Intrastate Gas.

Q. How about the pipeline group?

A. Without any doubt this area is the major battleground in our industry, as evidenced by the continued consolidation activity. In fact, many respected natural gas analysts now feel mergers and acquisitions may ultimately reduce the U. S. pipeline industry to a few major systems.

Our pipeline group felt the impact of this intense competition, as operating income fell approximately 13 percent despite a 6 percent increase in pipeline system throughput.

For the future, we remain optimistic that our strategic location in one of the most prolific and lowest cost gas supply areas in the nation will offer opportunities for increased earnings. This will be especially true as margins begin to expand with a return to more normal supply and demand conditions.

Q. What about exploration and production?

A. Arkla set an all-time company record for natural gas production, as net production increased for the fourth consecutive year up to 56 8 billion cubic feet.

Oil and condensate production was up even more, increasing 41 percent to 386,000 barrels.

In addition, we came close to replacing this production on an equivalent basis with new discoveries, extensions and reserve acquisitions, and our finding costs continue to be very competitive.

However, production increases were not able to offset the decline in average gas and oil prices, forcing operating income to fall 16 percent. Nevertheless, this still represents an adequate return on invested capital, and we are very optimistic about the long-term potential for our E&P operations.

We believe that superior returns are possible in this part of our business as pricing begins to recover.

Q. You mentioned difficult industry conditions. Has there been any meaningful change or improvement since last year?

A. There has been some improvement, but conditions remain difficult and uncertain.

Most of the federal regulatory "reform" is behind us now, and our industry is learning to cope with these changes. In addition, gas demand is improving, and this is slowly bringing gas supply and demand into balance. Ultimately, this should improve wellhead prices of gas and the margins pipelines are able to charge.

Natural gas is increasingly being recognized as "the fuel of the future," as concerns about dwindling domestic oil reserves, acid rain and the "greenhouse effect" gain national attention.

All of this spells a brighter future for the gas industry, but we must solve some serious, continuing problems first.

Q. What are those problems?

A. Arkla's three most immediate problems are low gas wellhead prices, tight pipeline margins and the financial effects of the prepayments we have made in settlement of various take-or-pay claims. All of these are largely due to the lingering oversupply of gas relative to demand.

Q. Is this the so called "gas bubble?"

A. Exactly. Although we cannot predict when the gas imbalance will end, it is really only a question of "when," and not "if." In fact, some gas analysts feel that, had we not experienced the unusually warm weather in December, 1988 and January, 1989, the imbalance would have been largely eliminated by the end of the current winter season.

As federal regulations restricting gas use have been eliminated, demand for gas has increased significantly over the last two years despite relatively low oil prices. Also, gas has remained a lower-cost alternative to oil — for boiler fuel use — and to electricity — for home heating. Meanwhile, available supply has been decreasing as reserve replacement nationwide has not kept up with production.

Therefore, we feel this problem is being cured from both a supply and demand aspect.

It is also becoming more apparent that heavy reliance on the spot market for gas can carry great risk. As the "bubble" diminishes, this will lead to higher prices, as end users seek more secure, longer-term sources of gas.

Our strategy is simple: find those customers and sell them our gas.

Q. You mentioned pipeline margins as another area of concern.

A. Our pipeline margins have been under intense pressure over the last few years due to competitive market conditions and the federal regulatory mandate to shift from our traditional merchant role to an "open access" transporter of gas.

The margin we are able to collect on transportation has proven to be significantly less than our traditional sales margin.

This margin pressure has been exacerbated by low gas prices and the development of the spot market. The spot market continues to make natural gas available to end users at prices considerably below the cost which pipelines have historically incurred to insure supply of gas for their customers.

Even though we have transported more gas in this environment, the throughput increase has not been able to overcome the margin decline.

Our response to this problem has been four-fold. We have (1) aggressively increased throughput to the highest margin markets available, (2) reduced costs, (3) redesigned rates to more accurately reflect the value of service provided, and (4) enhanced our pipeline's ability to move gas to any available market.

To date, these responses have helped, and we believe pipeline operating income has stabilized. In what we hope signals the beginning of a trend of improving pipeline results, we have recently signed an agreement with the Coastal Corporation, which will help achieve full utilization of our AER system and allow better movement of gas into new market areas.

Q. This brings us to the problem of "take-or-pay," which continues to plague the industry.

A. Without a doubt, the resolution of existing take-or-pay clauses in gas purchase agreements continues to be the most vexing problem facing our company and the industry.

The new set of rules that our industry operates under really makes this type of contract obsolete. However, we still have to settle and reform our existing contracts, and this is a costly proposition.

Although our industry has gone a long way in settling these claims from producers, the problem is far from solved.

Q. So what has Arkla done to remedy this situation?

A. We have chosen a different approach to settling these claims from that used by many other companies.

Thus far, we have been able to structure all of our settlements as prepayments for gas with full recoupment rights over the term of the agreement. We continue to feel we will ultimately recover the vast majority of the money spent in buying this gas in advance of delivery, but, in the interim, we continue to face challenges.